



Burning down the house

Government is not the solution to the housing crisis

Help to Buy will not end the housing crisis. The government's plans to increase liquidity in the housing market will do little to solve the UK's long-run housing supply shortage – and do much to aggravate high housing prices while improperly using the state as a risk transfer mechanism. Liberalisation, not intervention, is the best long-term solution for the distorted British housing market.

Executive Summary

1. The price of British housing is currently well above historical averages, a problem that demand-side fiscal intervention will worsen, not improve;
2. The government's equity loan and mortgage guarantee schemes will raise the height of all the rungs of the housing ladder by boosting house prices, and is best understood as assisting buyers by subsidising additional borrowing – raising affordability only for members of the scheme, and reducing it for everyone else;
3. The scheme redistributes wealth from taxpayers to house buyers, which may prove to be regressive and which exposes taxpayers to possible losses on every equity loan in its first five years of existence, with no guarantee of a return thereafter;
4. The scheme socialises the cost of what ought to be private transactions between private borrowers and private lenders, and encourages the mispricing of mortgage assets in such a way as to create the possibility of significant contingent liabilities for the British taxpayer;
5. More appropriate solutions exist to encourage new housebuilding, such as liberalisation of planning laws and the abolition of mandatory affordable housing in new developments. Only reforms that allow increases to the supply of British housing will truly solve the affordability problem and therefore solve the housing crisis, with the

added benefit that supply-side reform will be entirely revenue-neutral from the perspective of the public purse

Introduction

The UK's housing situation is bleak – despite a crash in the relative price of houses since the crisis, tightly squeezed incomes have ensured the house price-to-income ratio remains markedly above where it was at the beginning of the house price boom in the late 1990s. As a result, in the words of the Institute of Economic Affairs' Kristian Niemietz, "housing costs have become one of the most pressing issues for low-income households in the UK... [having] doubled in real terms since the mid-1990s alone, from an already very high level," with rent levels – social and private – rising commensurately.¹ "No other developed country except Australia has experienced a price explosion of such a magnitude," he adds, "not even Spain, with its notorious house price bubble, has quite paralleled the British experience."

Since then, the British housing problem has worsened, not improved. According to Shelter, British accommodation is among the most expensive in Europe. Prices have risen 4,300 per cent in the last 40 years; if the price of food had risen at a comparable rate over the same period, buying a whole chicken at a supermarket would today cost £51.18.²

In London, where property values are already 5.7 per cent above their pre-crisis peak according to official statistics, the affordability problem is still worse. Across England as a whole, where (based on figures from the Greater London Authority) the average house cost 3.54 times the median wage in 1997, by 2011 one cost 6.65 times the median wage, barely down from the 2007 multiple of 7.23. Though house prices have been broadly flat since then, real incomes have fallen in the interim, meaning – from the perspective of new entrants to the housing market – the ratio is still highly unfavourable.

Although there is a political consensus about the existence of a housing crisis, there is not one regarding how this crisis should be addressed. As put by a House of Commons briefing paper in 2010, “it has been clear for some time that housing supply is not keeping up with demand,” adding for good measure that there are “significant levels of overcrowding in the private and social housing stock.” However, the briefing continues, any reductions in the price of housing which accompanied the recession have done little to improve its affordability, as price reductions have been accompanied by “by tighter lending criteria, particularly larger deposit requirements” such that poor working families in rented accommodation, even assuming spartan personal budgets with little or no provision for incidentals, would need to save for several decades in order to purchase a home in most major urban centres.³

While there are myriad possible explanations for and solutions to the housing crisis, the 2013 Budget makes it clear that the government believes lack of access to finance is the primary problem and state intervention in the sector is the cure. Thus the government announced the Help to Buy scheme in the Budget to bring both on-balance sheet and off-balance sheet funds to those struggling to buy into the market, adding to significant state-backed credit-easing schemes which are already in place. “[T]he financial crisis in 2007 increased requirements for larger deposits and falling equity values have meant many credit-worthy households cannot get a mortgage, or are trapped in their existing homes unable to take the next step,” the Budget reads,⁴ political shorthand to say that many pre-crisis home purchases were not sound financial investments,⁵ and those homeowners are now in negative equity – owing more on their mortgage than their house is worth.⁶

To address this problem, the Government has implemented two stimulus schemes over the past 24 months: First Buy, which offers households earning less than £60,000 per annum with small deposits 95 per cent mortgages with government equity, and Funding for Lending (“FLS”), a collateral swap programme where the Bank of England lends gilts to participating financial institutions which use them in turn to borrow money at 0.25 per cent above the Bank’s base rate (provided that the banks in question then on-lend the funds to UK businesses and homeowners). Despite these fiscal and monetary interventions, however, net lending actually fell by £1.5bn in the first six months of the FLS.

Since the existing schemes have not brought about the housing renaissance desired, the government launched

two further programmes in the 2013 Budget:

- the Help to Buy new build equity loan programme, and
- the Help to Buy mortgage guarantee programme, available for high loan-to-value (“LTV”) loans made in respect of new-builds and existing housing stock.

This briefing paper outlines the key problems with these two schemes, and argues that supply-side reform would achieve the government’s ambition to make housing more affordable far more easily, while reducing the magnitude of potential harmful market distortions that the Help to Buy schemes might create.

Help to Buy

“Help to Buy” consists of two components. The first is a so-called “equity loan” whereby the Government will lend up to 20 per cent of the value of a newly-built home interest free for five years. From the sixth year, the government will charge an arrangement fee of 1.75 per cent on the amount of the loan, such fee to rise on a scale linked to RPI plus one percentage point each year thereafter. (By comparison, a typical 95 per cent mortgage charges closer to four per cent per annum in current conditions.) This element, an extension of the existing First Buy scheme, differs from its predecessor in that it raises the top price of an eligible home from £280,000 to £600,000 which, according to the government, means it will help not just those looking to get on the housing ladder, but those looking to move up it.

The second component is the so-called “mortgage guarantee,” which is designed to incentivise lending by offering lenders insurance on the mortgages they make, worth up to 80 per cent of the sale value of a pool of properties (and above such threshold firms will be required to absorb some of the losses on the pool). These guarantees, which (in exchange for a premium) indemnify participating lenders against the costs of default, foreclosure and repossession, will only be available in respect of loans with LTV ratios of 80 per cent or above, as (according to the government) mortgages with LTVs below that level are already widely available. Since, according to the Treasury, evidence shows that most defaults arise within the first seven years of origination, the guarantees will last only that long. Each bank will pool together the eligible loans it wishes to guarantee, and the guarantee will be applied to the pool as a whole.

Despite an only modest recovery in the wider economy, house prices continue to rise aggressively, especially in London where they increased 5.9 per cent in the year preceding February 2013, with the consequence that

housing stock in the capital's 10 most expensive boroughs is now worth more, taken together, than the entire property markets of Northern Ireland, Wales and Scotland combined. This is reminiscent of the Japanese land boom in the late 1980s, a bubble that saw the land value of the Imperial Palace in central Tokyo outstrip the entire GDP of Canada.

Available evidence therefore suggests that there has been something of a decoupling of house prices from reasonable expectations of land productivity. Depending on one's point of view, this might be called an asset price bubble. London generates 20 per cent of the country's GDP, houses 12 per cent of its population and is home to many of the nation's major commercial enterprises,⁷ and there are also other financial advantages to living in an urban area such as reduced transport time and cost. Whether such advantages, particularly in London where the housing shortage is most acute, confer a competitive advantage worth an average of 10% or more annual compound increases in the capital value of land is another question.

In the market of ideas, there are a number of compelling competing, and plausible, explanations for this rise in urban land values. The FT's John Authers, pointing out that "the shortest-term rates have never been 'so low, for so long, for so many,'" points out that a "'reversion to mean' awaits British, and in particular London, property."⁸ Nor is he alone in this opinion. As put by the prominent British economist David Miles in 2004, "house prices have risen greatly relative to incomes over the past ten years, though nominal interest rates have fallen to, historically, low levels which has, in itself, boosted affordability."⁹

Little about these key characteristics of the UK housing market has changed since then. As evidenced by the economic impact of the Help to Buy proposal itself, house prices continue to rise beyond affordable limits, and the scheme operates in an environment where money is so inexpensive that, as put by the Bank for International Settlements, interest's "low real long-term rate is well below... historical averages – [which is] perplexing on both macroeconomic and microeconomic grounds."¹⁰

Money for Nothing...

How, then, should we view the government's proposals? To recap, the government proposes to extend initially interest-free loans of up to 20 per cent of the value of a new-build home – i.e., solving the borrower liquidity aspect of the homebuying problem. For the first five years of each equity loan, government funding will be interest-free; in the sixth year, a fee of 1.75% will be charged on the outstanding

principal amount of the equity loan; and, thereafter, interest will be charged at 1% above (1.75% x RPI inflation).

This means that every Equity Loan will be lossmaking in the first five years of its existence, and from year 6 onwards, these loans will be made on terms which may not reflect a market standard. Even without considering the fact that available evidence currently indicates that the Equity Loan component has not spurred meaningful construction of new supply, this aspect of the Help to Buy scheme will take effect as a subsidy, meaning in practice that non-participating taxpayers, in addition to paying for the loans, will have to work against them as the infusion of government liquidity increases competition for limited supplies of land.

Subsidies that benefit classes of homeowners according to location typically capitalize into the value of the housing stocks which benefit from them. It is well-established that "windfall-type central government grants to a local government," such as in educational spending, highways and transport infrastructure, and rent assistance programs "capitalize fully into house prices, irrespective of whether the local government would use them to provide additional/better local public services or cut taxes."¹¹

The effects of non-pecuniary state intervention alone (to say nothing of a direct subsidy) are significant: studies suggest that existing forms of non-money amenities, such as planning permission, "[generate] benefits that are very unequally distributed... in a way that favours those who are already favoured with higher incomes," a net loss to the economy which is "equivalent to a tax on incomes of 3.9 per cent."¹² These costs are borne predominantly by the poor and the landless. According to one study on land use control in southern England, providing inaccessible open space added 3.54 percentage points to the Gini measure of inequality, and restraining the availability of industrial land added 0.92 percentage points.

Thus, one sees that while government subsidies start out with good intentions, and are meant to assist poorer homebuyers, such state intervention – even if directed solely at new-build housing – will have the effect, in aggregate, of raising the pricing of all housing, whether new-build or not, to the extent that the new-build and existing housing stock is exchangeable to end consumers, while providing only a limited impact on available supply. Higher prices mean reduced affordability, notwithstanding the credit-easing impact of the scheme. And the poorest potential homebuyers, whose circumstances preclude access even to Help to Buy, are the ones who will suffer most.

...Risk for Free

Additionally, the Government has promised to reduce the level of risk to which lenders are exposed when lending into the new-build housing sector by guaranteeing up to 80 per cent of the value of a portfolio of high-LTV loans on bank balance sheets for up to £12bn worth of mortgage loans in order to promote £130bn worth of lending into the sector.

At first glance, this might seem a politically acceptable approach to supporting homebuying in an age of austerity, fitting for the Coalition platform: 'it's a guarantee, not a hand-out; aspiring, not scrounging; balance sheet neutral and risk free.' However, observing what transpired when this approach was attempted in the United States, one should understand that such an approach is not, in fact, without its risks.

Like the British government does today, the American government once waded into the mortgage guarantee business through a number of government-sponsored private enterprises (GSEs) – particularly the Federal National Mortgage Association, known as Fannie Mae, and the Federal Home Loan Mortgage Corporation, known as Freddie Mac, both of which played a central role in the U.S. housing market for decades by purchasing mortgages and pooling them for securitisation. The primary benefit of GSE involvement in providing liquidity to the residential mortgage market was that the strength of the AAA American sovereign credit was implied upon the GSEs, reducing interest rates for, and increasing liquidity to, the housing sector, widening access in much the same way the government proposes to do with Help to Buy.

The primary risk inherent in guaranteed lending, however, is that it is priced on the expectation that the government will step in if anything goes wrong. In the case of Freddie and Fannie, a contingent liability to the government arose in respect of either of the GSEs' obligations: if Fannie and Freddie got into financial trouble, the extent to which the taxpayer was potentially liable was the difference between (1) the prices at which Fannie and Freddie issued their debt, and (2) the price Fannie and Freddie would have to pay the private sector to take on those risks in the event of a default.¹⁴ This difference in the pre-crisis United States was roughly 0.4 percentage points. However, with combined assets of over \$5 trillion, 0.4 percentage points represents a very substantial figure; and when the bubble burst, the American public found itself faced with the task of absorbing the loss.

The Government, by guaranteeing private sector mortgage lending, cannot escape the possibility that it might expose the British taxpayer to the same differential: the reduction in interest rates and increase in liquidity which the guarantees purchase is paid for by the increase in contingent risk in the event of widespread defaults, in respect of which the guarantees would then be called in. Considering the current distance of British house prices from their historical mean, distressingly little has been said on the point in mainstream media to date.

Key objections

What seems clear from even a brief survey of opinion across policy institutes, industry watchers and academia is that, except for the construction industry and industrial landlords, the average consumer of land has much to lose and little to gain from these proposals:

- the price of British housing is currently well above historical averages, a problem that fiscal intervention will worsen, not improve;
- the schemes will raise the height of all the rungs of the housing ladder by boosting house prices, as well as lifting buyers by subsidising additional borrowing – and are unlikely to raise affordability in the long term;
- the taxpayer will make a loss on every Equity Loan in its first five years of existence, with no guarantee of a return thereafter;
- the mortgage guarantee component socialises the risk of what would otherwise be private transactions between private borrowers and private lenders, introducing the possibility of a significant contingent liability which, if crystallised, would be borne by the British taxpayer; and
- supply-side solutions exist to encourage new housebuilding which would increase the supply and affordability of British housing while remaining entirely balance sheet-neutral, but the Government has not thus far shown the political fortitude necessary to embrace them.

A number of such supply-side solutions have been proposed by the ASI and/or its affiliates on numerous occasions in the recent past, including releasing limited amounts of farmland for suburban development, radical liberalisation of urban planning laws (proposed by ASI Fellow Tom Papworth), and the abolition of mandatory affordable housing provision in new housing development (proposed by ASI Fellow Preston Byrne). The full contents of these arguments do not bear repeating here. What such solutions have in common, however, is that the obstacles to their implementation are political and regulatory, not economic.

Viewed thus, government is not the solution to the housing crisis: government is the housing crisis. With credit as inexpensive as it is today, injecting additional credit which is still less expensive into the housing market does not seem a prudent or particularly effective long-term solution.

Mortgage subsidies promise more debt, more taxes and unnecessarily socialised risk. Radical liberalisation, on the other hand, presents the possibility of making an immediate and significant impact on the housing crisis, freeing up national income for productive enterprise and resulting in a measurable improvement in the standard of living for ordinary people – while keeping risk where it belongs: with property lenders, purchasers and developers, not taxpayers.

Endnotes

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